Introduction

The purpose and goal of a compliance examination is to determine the extent and effectiveness of a savings association's management efforts toward assuring compliance with laws and regulations, and maintaining a solid, operational and viable internal compliance program.

Compliance examinations are to be conducted using a "top-down/risk-focused" approach. This approach, which is also used to perform safety and soundness examinations, places emphasis on a savings association's demonstrated ability to manage its compliance responsibilities. In performing this approach, consideration is given to the savings association as a whole, taking into account all operations conducted, however legally structured. This means focusing on the association's compliance program for performing regular oversight and monitoring of its own activities, as well as those activities conducted through affiliated organizations or third party vendors. Activities conducted through an affiliate, subordinate organization or third party vendor, present varied risks to a savings association that warrant regular oversight.

The deployment of the "top-down/risk-focused" approach generally involves the comprehensive review and analysis of internal policies, procedures, and review programs as a basis for assessing compliance with the consumer protection and public interest laws and regulations, particularly those that fall within high-risk and high sensitivity areas. Additionally, applying this approach means the examiner determines whether an association's risk management systems and controls are implemented in a manner that leaves no subsidiary, affiliate, or third party service vendor outside of its compliance monitoring scope. After formulating an initial assessment of an association's overall compliance efforts from a comprehensive review of policies and the like, the examiner tests the integrity of the internal compliance program through limited sampling of various selected transactions on a risk-basis. The examiner evaluates compliance generally by focusing on high profile areas and limits the review of other laws and regulations to the extent necessary to evaluate the compliance posture of the association.

The approach presumes that formal enforcement actions will be taken when examiners encounter unsatisfactory compliance programs or otherwise severe instances of noncompliance with laws and regulations. Without this concomitant enforcement, the top-down and risk-focused approaches loses effectiveness and meaning and associations will continue to look to the examiner as its primary means of determining whether it is in compliance. It is incumbent upon management to demonstrate that it has incorporated compliance into its daily operations.

Moreover, given that the agency's limited compliance resources must be used efficiently, examinations of savings associations that have not developed viable compliance programs should generally be promptly terminated after a meeting with senior management or the board of directors is held to notify them of their inadequate program, that the examination is being terminated and rescheduled. A reasonable but short period of time should be given to institute appropriate procedures and be informed that if a compliance program is not in place by the next examination that enforcement action may be initiated. This decision should be followed-up with a strong, written communication from Regional management that stresses the importance of an internal compliance program. Typically, the termination of an examination will be generally applicable to, and was primarily designed for, those associations undergoing their first separate compliance examination.

Examination Overview

The compliance examination process is intended to be risk-focused and to clearly place the responsibility for having an acceptable compliance program with the board of directors and management. Because of the nature of the compliance subject matter, it is extremely difficult to make value judgments to render a particular legal requirement within a regulation more or less important than another requirement in the same regulation. It is possible, however, to focus ex-

sible, however, to focus examination efforts on particular aspects of a given law and reach a supportable conclusion about compliance with that law without looking at every conceivable requirement.

Although the procedures for each compliance law and regulation cover all legal requirements, not all associations will be subject to every provision of a compliance law or regulation by virtue of differences in product and service offerings. Consequently, many of the procedures for certain requirements will not be applicable to a given association. The objectives of including all requirements in the procedures are to provide detailed guidance to examiners and to assure that sufficient information is presented to assist in the testing of individual transactions and disclosures for compliance and consistency with written and articulated practices.

The "top-down" approach, as augmented by the risk-based review as defined herein, enables the examiner to take a systematic, reasoned approach to the conduct of an examination, while at the same time streamlining the process for purposes of efficiency and effectiveness. It moves the entire examination process away from one in which a review of transactions in all areas forms the basis of the examination to one in which a review of policies and procedures are used to pinpoint areas of weakness for further, more exacting study.

Pre-examination Analysis and Scoping

The pre-examination review and analysis process involves the review of information from all available sources including the association and Regional records. This review and analysis should be broad enough to obtain an understanding of the organizational structure of the association, its related activities, and risks associated with each of its activities. Further, the review is necessary to determine whether association management identifies, understands, and adequately controls the entire spectrum of risks facing the association. In general, management is expected to have a clearly defined system of risk management controls embracing all areas of operations, including those activities conducted by affiliates, subordinate organizations or third party vendors.

This pre-examination review and analysis should generally be conducted off-site by the Examiner-in-Charge sufficiently before the start of the examination to help ensure that the items of highest risk have been identified.

Prior to the beginning of an examination, the association should be sent a Preliminary Examination Response Kit (PERK) for Compliance. The PERK asks for information on the association's policies, procedures, practices, copies of blank forms, CRA comments, and other salient data. In addition, each Regional office has a wealth of information about the association in its records such as prior compliance and safety and soundness examination reports, Thrift Financial Reports, aggregate Home Mortgage Disclosure Act data, consumer complaints, and other supervisory correspondence and enforcement actions. Pertinent information should be reviewed prior to the on-site portion of the examination to assure that the examination is conducted in an effective and efficient manner.

On-site Examination

During the on-site portion of the examination, the examiner conducts detailed interviews and discussions with the Compliance Officer, Senior Management and the Internal Auditor, as applicable. This interview process helps the examiner document how management of the association views compliance and incorporates it into daily operations. Information from the interview process should be used to amend the scope of the examination if necessary by better identifying, which aspects of which laws need to be reviewed in more depth.

Examiners should review and evaluate an association's written compliance policies, written operating policies such as loan underwriting guidelines, the quality of the compliance program as measured by the depth of management involvement and commitment, the findings of internal or external reviews, the degree to which the association has corrected violations and procedural deficiencies identified as a result of these reviews or the previous examination and the materials requested prior to the examination.

The review of internal policies and procedures really encompasses two levels of analysis. The first

is whether there is, or should be, a policy or procedure in place to address a recommended or required topic. The second is an analysis of the content of the policy or procedure itself. For example, a written loan policy should be looked at to determine the types of credits that are being offered by the association, and, at the same time, should be reviewed to determine that it does not contain any discriminatory overtones inconsistent with applicable legal requirements.

A review of this material places the examiner in the position to formulate hypotheses about the association's overall compliance performance for testing. There are no restrictions on the number or extent of these hypotheses, and their composition will vary among associations. However, the examiner's preliminary assessment of an association's performance will probably fall into one of three main categories. The examiner should have either a favorable or unfavorable impression, or an uncertain belief about the association's performance in any one or a number of areas.

As a cautionary note, the examiner should keep in mind that a good public relations effort can mask serious regulatory or programmatical flaws and that the integrity of a seemingly successful program still needs to be evaluated. On the other hand, despite the absence of a cohesive compliance effort, or in instances where a fragmented or departmentalized compliance approach is used by an association, it is possible that few regulatory violations will be noted.

Review of Regulatory Areas

Each of the compliance laws and regulations can be sorted into either a Core Group or a Sensitivity-Based Selection Group.

Core Group

Laws and regulations in the Core Group are as follows:

Fair Lending

12 CFR 528 - Nondiscrimination
Regulation B (discrimination issues only)
Fair Housing Act
Home Mortgage Disclosure Act

Community Reinvestment Act

Regulation Z (calculation aspects only)
OTS Mortgage Regulations (notifications and accuracy of adjustments only)

Bank Secrecy Act

All applicable procedures in the Handbook sections for these Core Group laws and regulations (or specific aspects of these laws and regulations as noted above) will be conducted at every regular compliance examination. Testing for compliance should be entirely judgmental and statistical sampling should not be used as a matter of course.

Sensitivity-Based Selection Group

All other laws and regulations (as well as those other aspects of Regulations B, Z, or the OTS Mortgage Regulations not included in the Core group) fall into the Sensitivity-Based Selection Group. Factors to consider in making the selection of laws for review are the length of time since the last review for compliance with a particular law or regulation, the extent of any current sensitive issues associated with aspects of the laws, and any other information or findings by the examiner. Advisories from the Washington office on areas of high sensitivity will be issued periodically. Each Regional office is also encouraged to ask their examiners to include in their scope matters of known local concern. Examiners are given flexibility in making this selection, but must exercise good judgment.

It must be recognized that not every law and regulation in this grouping is going to be reviewed at every compliance examination. Given that the focus of the compliance examination is on the association's management and not on individual laws and regulations, evaluating an overall compliance performance level can be done without looking at every law and regulation. Moreover, complete reviews for those laws and regulations selected will

be the rare case - the focus should be on various aspects of those laws depending on the known weaknesses of the association, areas where other associations have experienced problems, aspects of laws and regulations that have changed significantly since the last examination, and any new laws or regulations. In no event, however, should two regular compliance examinations take place for which a particular law is entirely omitted.

The purpose of this stage of the examination process is to test the integrity of management's program while focusing on "sensitive" or "risk-prone" areas. These areas will change from one examination to the next. More importantly, the exclusion of these laws and regulations from the scope of the examination is not optional or discretionary. The idea is to focus the examiner's energies on important, sensitive subjects and to minimize the time spent on areas where the likelihood of problems is small.

After the selected regulatory areas have been reviewed, the examiner is in the position to summarize findings and reach a conclusion as to the compliance and CRA performance level of the association. The examiner should have enough information at this point to assign ratings to the association.

Once the findings have been summarized and documented, the examiner should have a final closing meeting with management of the association. The meeting should be attended by the managing officer of the association, the compliance officer, the internal auditor, and any other personnel that management would like to have attend. The findings of the examination should be discussed and corrective measures should be elicited from management.

Based on the severity of the deficiencies, the examiner should determine whether a Board of Director's meeting should be called to discuss the examination findings. In situations involving 3, 4, and 5 compliance ratings or Needs to Improve and Substantial Noncompliance CRA ratings, the normal practice is to have such a meeting.

Examination Types

There are three types of compliance examinations: regular examinations; targeted examinations; and special examinations. These are identified in the Compliance EDS as types 60, 61, and 62, respectively.

A *regular examination* is an examination of an association in which all necessary and applicable regulatory procedures are performed by the examiner. The regular examination is triggered by the association's rating at its previous examination and conducted in accordance with the frequency schedule explained in this section. An association is always assigned ratings for compliance and CRA performance at a regular examination.

A *targeted examination* is an examination conducted to address action taken by management to correct items of concern noted at the most recent examination, including a review of any new activities of an association that are subject to the laws and regulations normally considered during a regular examination and determining the degree of compliance with any supervisory directives or more formal enforcement actions. No compliance rating is assigned. No CRA rating is assigned, and no public CRA Performance Evaluation is prepared. If the targeted examination discloses serious new deficiencies, or a general decline in performance, then the targeted examination should be discontinued and a regular examination should be commenced.

A *special examination* is an examination conducted in response to dictated circumstances. For example, should the Regional Office receive a consumer complaint alleging discrimination whose disposition would necessitate an on-site investigation of the association, a special examination should be conducted. Other circumstances can occur that may trigger a special examination. One example is when regular examination findings indicate activities conducted on behalf of the savings association by a functionally regulated entity (excluding thrift holding companies) pose a material risk to the savings association and association management is deficient in monitoring these activities. Under this scenario, regular examination findings/concerns relating to the functionally regulated

entity's activities must be thoroughly documented, and discussed with Regional Office Counsel and the Assistant Regional Director. Additionally, consult the latest Agency guidance regarding examining functionally regulated entities. Subsequently, a determination will be made on whether to commence a special examination of the functionally regulated entity in accordance with the requirements of the Gramm-Leach-Bliley Act. If a decision is made to conduct a special examination of a functionally regulated entity, it must be coordinated with the entity's primary regulator.

An association cannot be assigned new ratings as a result of any special examination.

Frequency Schedule

Section 712 of the Gramm-Leach-Bliley Act ("GLBA") provides for an extended CRA examination cycle for institutions with aggregate assets of not more than $250 million. An association will be considered within the $250 million asset limit provided its year-end assets do not exceed $250 million for two consecutive calendar year-ends. A thrift qualifying for extended cycle treatment will have a CRA public evaluation performed after 48 months if its last CRA rating was Satisfactory, or after 60 months if its last CRA rating was Outstanding. A thrift receiving extended cycle treatment for CRA purposes will have "compliance only" exams scheduled on or about the midpoint of the CRA cycle if the institution is 1 or 2 rated. If the institution is rated 3 or worse for compliance at any exam, a subsequent compliance examination will be conducted in accordance with the normal schedule.

Under Section 712 of GLBA, OTS may conduct a CRA public evaluation of an association within a period less than the extended interval when it has reasonable cause. Reasonable cause may be based on consideration of the following factors: a material change in the size of the geographic area of the retail market served by the institution; a substantial decrease in lending volume; merger or acquisition of the thrift; a substantial alteration of the credit product mix offered by the thrift; identification of discriminatory or other illegal credit practices; or the presence of consumer complaints or community comments that reflect significant deterioration of CRA performance. A region should consult with Compliance Policy when evaluating whether the factors considered are sufficient to warrant a reasonable cause examination.

An association should receive regular examinations based on the lowest rating (compliance and CRA) assigned at its last regular examination. The following frequency guidelines are designed to concentrate resources on those associations whose performance is less than satisfactory for either compliance or CRA. Intervals are defined in relation to the examination report transmittal date of the previous examination. If wide differences exist between the CRA and compliance ratings, an examination focusing on the lower rated area only may be conducted. However, the Regional Office should discuss the matter with Compliance Policy before the scope of any regular examination is significantly limited.

Associations assigned the following ratings should receive regular examinations based on the following monthly intervals:

Compliance	CRA	Frequency
1	Outstanding or Satisfactory	24 to 36
2	Outstanding or Satisfactory	24 to 36
1 or 2	Needs to Improve	12 to 18
3 or 4	Outstanding or Satisfactory	12 to 18
3 or 4	Needs to Improve	12 to 18

Compliance	CRA	Frequency
5	Outstanding, Satisfactory, Needs to Improve, or Substantial Noncompliance	6 to 12
1, 2, 3, or 4	Substantial Noncompliance	6 to 12

These intervals provide a range within which a compliance examination for an institution must be

scheduled. For example, the next compliance examination of an institution with a compliance rating of "2" and a CRA rating of "Satisfactory" should be scheduled for as soon after 24 months as possible.

The Regional offices may conduct regular examinations on a shorter cycle or supplement regular examinations with targeted examinations, should resources permit or circumstances warrant. However, in scheduling examinations it should be remembered that associations most recently rated in the "3," "4," or "5" categories for compliance or in the Needs to Improve or Substantial Noncompliance categories for CRA are in need of more than normal examination attention. Consequently, the scheduling of regular examinations of these associations should be considered before conducting more frequent examinations of satisfactorily performing associations.

De Novo Institutions

Characteristics of de novo institutions may vary since some may be affiliated with established institutions or their holding companies, thus having operating procedures, and some may be beginning operations from the ground up, thus not having any organizational structure or operating procedures. These characteristics should be considered in determining the region's compliance oversight for a particular institution.

Regions are encouraged to communicate the agency's expectations to management during the application process to ensure that management of the de novo institution fully comprehends its compliance and CRA responsibilities. For example, the agency's expectations can be communicated through meeting with management and by providing management with a copy of the Compliance Activities Handbook for their review.

Commitments obtained during the applications process and conditions included in the approval orders are often not included in the institution's business plan. Examiners must carefully consider these commitments and conditions when scoping on-site visits to, and compliance examinations of, de novo institutions, and consult the regional and Washington application digests and the institution's final business plan.

Regions are also encouraged to have compliance examination staff conduct an on-site field visitation to the institution within six months of the commencement of operations to review progress toward developing an effective compliance and CRA program.

An initial compliance examination of a de novo institution should be conducted within 12 months after acquisition of an existing institution or the start of operations for a new institution. A twelve-month examination cycle will continue until management has satisfied all conditions imposed at the time of approval and there are no significant supervisory concerns.

Compliance examinations of de novo institutions should be conducted concurrently with safety and soundness examinations, whenever practicable.

Affiliated Organizations

Competition in the financial services industry continues to grow encouraging savings association and other financial institutions to expand their services and products. As a result, associations have come to rely on "affiliated organizations" (subsidiaries, service corporation, other affiliates, or partnerships) and third party vendors to perform key business functions. In some instances, the association is an affiliate of a diversified holding company structure and provides banking services as an element of a larger financial operation directed at the parent company level.

Affiliated organizations or third party vendors provide savings association customers with services and products the association may be prohibited from engaging in directly or would need to develop at great expense. Having this type of distribution channel enables an association or its parent to offer products and services responsive to the diverse needs of its customers. Furthermore, this business strategy benefits both the association and its customers. However, offering products and services through affiliated organizations or third party vendors, also presents a variety of risks to the savings association. These include, but are not limited to, operational risk, consumer protection risk, counterparty risk, regulatory risk, and reputation risk. An association's failure to establish a compliance risk management program to adequately identify,

measure, monitor, and control these risks in its products and business lines is an unsound management practice.

Assuring appropriate compliance oversight of an association's operations when conducted through affiliate organizations or third party vendors, means association management must demonstrate to the examiner that its compliance risk management program is effective and encompasses association operations as a whole, however legally structured.

Association management cannot abdicate its compliance risk management responsibilities to an affiliate, subordinate organization, or third party vendor. Therefore, examinations must ensure that a savings association's compliance risk management systems and controls are implemented in a manner that reviews affiliate, subordinate organizations, third party vendors, or other forms of delivery that fulfill the institution's business plan.